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Buffett's Bet

Warren Buffett's annual letter to Berkshire Hathaway shareholders always contains valuable insight and nuggets of wisdom for investors. Proponents of active management, who typically heap praise on Buffett's investing prowess, are unusually quiet this year because in his 2017 letter their hero publicly chastises their business model. Buffett describes a wager that he made nine years ago, that "*Over a ten-year period commencing on January 1, 2008, and ending on December 31, 2017, the S&P 500 will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs and expenses.*" He believed that no investment professional could select a group of at least five funds that invest in multiple hedge funds (called a fund-of-funds) that would outperform the Vanguard S&P 500 Index Fund over the subsequent decade. Each side would buy $320,000 of zero-coupon U.S. Treasury securities which will be worth $500,000 by yearend 2017. The winner will donate the $1 million to the charity of his choice.

Thousands of hedge fund managers, who make overconfident bets with other people's money, earn millions of dollars in fees from investors who believe that they possess the expertise to outperform a buy-and-hold strategy. Only Ted Seides of Protégé Partners – which manages a fund of funds - took the bet. Seides picked five funds-of-funds whose results will be averaged and compared to the Vanguard S&P 500 Index Fund. The five funds Seides selected invest in more than 100 hedge funds, a level of diversification that guarantees the overall performance of the selected funds will not be distorted by the results (good or bad) of just one hedge fund manager. The downside of this strategy is that each fund-of-funds adds another layer of fees to those charged by the hedge funds in its portfolio and the wager's winner will be determined by performance, net of fees.

Why would Buffett bet against some of the smartest money managers in the country? Each manager of the underlying hedge funds has a financial incentive to do his or her best and the managers of the five funds-of-funds are similarly incentivized to select the best hedge funds to place in their portfolios. Buffett was confident that the high management fees and expenses of the hedge funds would leave their investors – in aggregate – worse off than the "dumb money" invested in an unmanaged index fund; no matter which funds were selected.

Through the end of 2016, with one year left to go in the bet, the Vanguard fund is up 85%. The five funds-of-funds chosen by Seides are up an average of just 22% (ranging from 2.9% to 62.8%). The average annualized return for the Vanguard fund has been 7.1% vs. 2.2% for the five selected funds. $100,000 invested equally among the five funds was worth $122,000 by the end of last year vs. $185,400 if invested in the Vanguard fund. According to Buffett: *"I estimate that over the nine-year period roughly 60% of all gains achieved by the five funds-of-funds were diverted to the two levels of the managers."* (Note: this means that the fees paid by fund investors exceeded their net gain.) "*That was their misbegotten reward for accomplishing something far short of what their many hundreds of limited partners* (fund investors) *could have effortlessly – and with virtually no cost – achieved on their own."* Although nine months remain before the winner of the bet will be determined, I doubt that Buffett's claim of victory is premature.

The reasons cited by Buffett for the underperformance of the hedge funds are similar to those made by William Sharpe in his 1991 article: The Arithmetic of Active Management. Every investor is in one of two categories -- active or passive. Passive investors own all stocks in the same percentage as the market itself. If a particular stock represents 1% of the market capitalization of domestic stocks, passive investors will have a 1% allocation to this security. This can be easily accomplished by owning a total stock market index fund.

All other investors are active investors. Their portfolios differ from the passive portfolio because active investors shun stocks that they feel are overpriced and overweight stocks that they feel are undervalued. Every dollar invested in the stock market is owned by either a passive or an active investor.

Each passively invested dollar will earn the market's return. If all passive dollars are removed from the market only active dollars remain. We have no way of knowing what any actively managed dollar will earn but the average return of all actively managed dollars must equal the market's return. Although active and passive investors employ different strategies, both groups receive the same return -- before expenses. However, active investors incur greater costs so as a group, the average active investor will underperform the passive investor. As Buffett states: *"A lot of very smart people* *set out to do better than average in securities markets. Call them active investors…However, these investors will incur far greater costs. So, on balance, their aggregate results after these costs will be worse than those of the passive investors…A number of smart people are involved in running hedge funds. But to a great extent their efforts are self-neutralizing, and their IQ will not overcome the costs they impose on investors".* Many hedge fund investors have learned this lesson the hard way.

Even the smartest active managers, employing complex mathematical models, struggle to successfully outperform a passive investment strategy. If the great majority of money managers fail to outperform the market, it's unlikely that any actively managed fund or strategy that you're being pitched will be the rare exception that outperforms.

Buffett noted: "*The bottom line: when trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low-cost index funds."*

I believe that Seides took a sucker's bet. The great majority of actively managed funds of all sorts – i.e., hedge funds, mutual funds, endowments, pension plans, etc. – underperform the market, net of fees. The best strategy to win the bet would have been to choose one hedge fund and hope for the best. By selecting five funds that invest in over 100 individual hedge funds, Seides needed at least half of the underlying hedge funds to outperform the S&P 500, net of fees. The chances of this happening were almost nil.

In recent years, the percentage of professional money managers who produce market beating returns, after fees and taxes are deducted, has been on a steady decline. Here are several reasons this trend will likely continue –

- The number of amateur investors participating in the stock market has been declining. It is estimated that retail investors' share of the stock market has fallen from about 90% in 1945 to less than 20% today. Fewer patsies playing the game means that there's less easy money to be made by the professionals.
- While the number of retail investors has declined, the number of professional money managers has increased. All of them are searching for mispriced securities. A mispriced security will attract millions of dollars as soon as the mispricing is discovered – quickly eliminating the mispricing.
- Trading costs have fallen dramatically. As long as it costs almost nothing to trade, trading volumes will remain elevated and the market's pricing efficiency will remain high – leading to smaller and less numerous stock mispricings.
- A rarely noted cause of the disappointing performance of active managers in recent years is the "paradox of skill". The average level of manager skill has increased, yet it hasn't benefited investors. This is because only "relative skill" provides an edge in the "beat the market" game. The number of managers who possess relative skill declines as the average skill of all managers increases. In other words, smarter competitors means fewer outperformers.
- Most active managers trade frequently and profits on stocks held less than one year are short-term capital gains. For funds held in taxable accounts, short-term gains are taxed as ordinary income; not at the lower long-term capital gains tax rate. Higher taxes hurt fund investors but not fund managers - who always advertise pre-tax returns.

Buffett's annual letter usually contains an optimistic view of America's future. There have always been dark clouds on the horizon. It requires no special insight to complain about politics, the budget deficit, the trade deficit, terrorism, or whatever occupies today's headlines. Hot wars, cold wars, depressions, inflation, government and corporate corruption have come and gone. The pessimists have always been wrong. As Warren Buffett noted in this year's letter – "*Ever-present naysayers may prosper by marketing their gloomy forecasts. But heaven help them if they act on the nonsense they peddle…Early Americans, we should emphasize, were neither smarter nor more hard-working than those people who toiled century after century before them. But those venturesome pioneers crafted a system that unleashed human potential, and their successors built upon it. This economic creation will deliver increasing wealth to our progeny far into the future. Yes, the buildup of wealth will be interrupted for short periods from time to time. It will not, however, be stopped. I'll repeat what I both said in the past and expect to say in future years: babies born in America today are the luckiest crop in history."*

Buffett concluded this year's letter by praising Vanguard founder John Bogle. *"If a statue is ever erected to honor the person who has done the most for American investors, the hands-down choice should be Jack Bogle. For decades, Jack has urged investors to invest in ultra-low-cost index funds. In his crusade, he amassed only a tiny percentage of the wealth that has typically flowed to managers who have promised their investors large rewards while delivering them nothing – or, as in our bet, less than nothing – of added value. In his early years, Jack was frequently mocked by the investment management industry. Today, however, he has the satisfaction of knowing that he helped millions of investors realize far better returns on their savings than they otherwise would have earned. He is a hero to them and to me."* And to me.

Do Long-Tenured Fund Managers Outperform?

In many areas of life, aviation being a perfect example, there's no substitute for experience. Financial advisors and their clients have been influenced, perhaps unconsciously, by Wall Street's relentless propaganda that long-tenured, fund managers have a level of relative skill that can produce consistent outperformance. Andrew Clare, professor at City University, London recently published the paper: "The Performance of Long-Serving Fund Managers" in which he attempted to discover if long-tenured fund managers possess special skill.

Clare studied the performance of 357 actively managed US stock mutual funds that had just one manager for at least ten years as of December, 2014. He compared each fund's return, net of fees, to the fund's benchmark index from January 2005 through December 2014. The good news for fans of active management is that, in the decade under study, 60% of the managers outperformed their benchmark index and, as a group, the 357 funds outperform their benchmarks by an average of about 0.5% per year. Unfortunately, there was no way for investors in 2005 to identify these 357 funds from the thousands of available stock funds.

Although the funds, as a group, outperformed their benchmarks over the decade under study, Clare found little performance consistency in the individual funds from one year to the next. Outperformers in one year were unlikely to beat their benchmark in the next year. In six of the ten years under study, as well as over the final four years, these long-tenured managers, as a group, underperformed their benchmark indexes. The performance inconsistency of these funds likely caused many shareholders to lose faith, sell their shares and miss the funds' long-term performance bonus.

These results are similar to a study that tracked the performance of 93 experienced fund managers from 1986 through 1995. Researchers found little evidence of performance persistence among these managers. Additionally, a fund's performance in the first five years of the study was not predictive of its performance in the last five years of the sample.

A 2012 study of 289 active managers with at least ten years of tenure found that there was a decline in performance as managers became more experienced. The study concluded that managers often earn their reputations by outperforming early in their careers. As their performance becomes well-known, it attracts new investors; which extends manager tenure despite less than impressive subsequent performance.

A 2014 study found no evidence of performance persistence among long-tenured managers and concluded that the key to a successful career in fund management has more to do with avoiding underperformance than generating outperformance.

These studies reinforce the often noted, but rarely heeded, warning that past performance is no guarantee of future returns – regardless of the asset class, manager tenure or the marketing propaganda of fund companies. Here are three reasons why past performance is a deceptive measure of manager skill -

- There are almost 10,000 actively managed domestic stock mutual funds. Some will outperform over the next decade by pure chance, making it virtually impossible to judge if manager skill was the cause. If past performance was a reliable indicator of manager skill, there'd be just one very big stock fund instead of the thousands we have today.
- A fund that outperforms its benchmark index with lower volatility is a rare bird indeed. Mutual fund companies hope investors attribute fund performance to manager skill. But high performing fund managers often take more risk, making their funds more volatile than a comparable index fund. Mutual fund advertisements that do not compare fund volatility vs. its benchmark may be factually accurate but are intentionally deceptive.
- Many benchmark beating active funds incorporate "style drift". For example, a large-cap stock fund that uses the S&P 500 Index as its benchmark may have a portion of its portfolio invested in small company stocks. Over the past 90 years, small-cap stocks have outperformed the S&P 500 Index by an average of about 2% per year. If a large-cap fund manager invests in small-cap stocks in a year when small-cap stocks outperform large cap stocks (such as 2016), beating the S&P 500 is likely the result of style drift, not manager skill.

The illusion of manager skill is kept fertilized and well-watered by Wall Street's representatives; whose livelihoods depend on the perpetuation of that illusion. It is impossible to know whether a long-tenured manager's periods of outperformance demonstrate relative skill or the favor of Lady Luck. And as long as investors remain unaware of the hidden impact that pure chance has in fund returns, they'll continue to misallocate capital to active managers and, in Warren Buffett's words: *"it will usually be the managers who reap outsized profits, not the clients*."